The Commonwealth of Massachusetts

DEPARTMENT OF
TELECOMMUNICATIONS AND ENERGY

D.T.E. 04-52 August 27, 2004

Investigation by the Department of Telecommunications and Energy on its own motion as to the propriety of the rates and charges set forth in the following tariffs: The Berkshire Gas Company, M.D.T.E. Nos. 343 through 349, filed on May 14, 2004, to become effective September 1, 2004.

APPEARANCES: James M. Avery, Esq.
Brown Rudnick Berlack Israels, L.L.P.
One Financial Center
Boston, Massachusetts 02111
FOR: THE BERKSHIRE GAS COMPANY
Petitioner

Thomas F. Reilly,
Attorney General of the Commonwealth of Massachusetts
By: Alexander J. Cochis, Esq.
Assistant Attorney General
Utilities Division
One Ashburton Place, Room 1813
Boston, Massachusetts 02108-2406
Intervenor

I. INTRODUCTION

On May 14, 2004, The Berkshire Gas Company ("Company"), pursuant to The Berkshire Gas Company, D.T.E. 01-56 (2002), filed with the Department of Telecommunications and Energy ("Department") the Company's first annual compliance filing ("Compliance Filing") under performance based regulation, proposing to revise tariffs M.D.T.E. Nos. 343 through 349. The Company proposes a $252,197 increase in annual normalized revenues, which amounts to a base revenue increase of 0.92 percent, based on the price cap formula adopted in D.T.E. 01-56 (Compliance Filing at 1). This matter was docketed as D.T.E. 04-52.

Pursuant to notice duly issued, the Department sought comments on the Company's Compliance Filing. On June 29, 2004, the Attorney General of the Commonwealth of Massachusetts filed comments ("Attorney General Comments"). On July 12, 2004, the Company filed reply comments ("Company Reply Comments"). The Company responded to 22 Department information requests.[1]

II. COMPANY'S COMPLIANCE FILING

The Company's price cap formula provides for an annual adjustment to the Company's rates by taking the previous year's normalized base revenues (after service quality penalty

---

[1] The Department, on its own motion, moves the Company's responses to Information Requests DTE-1-1 through DTE-1-8, DTE-2-1 through DTE-2-4, DTE-3-1 through DTE-3-7, and DTE-4-1 through DTE-4-3 into the evidentiary record in this case.

adjustments)[2] and increasing that number by a factor comprised of an inflation index, minus a productivity growth offset, plus an exogenous cost factor (when applicable). D.T.E. 01-56, at 12. The inflation index is calculated as the percentage change between the average of the current year's and prior year's four quarterly measures of the Gross Domestic Product chain weighted Price Index ("GDP-PI") as of the first quarter of the year. D.T.E. 01-56, at 20-21.

The Company states that its normalized base revenues for 2003 were $27,325,543 (Compliance Filing, att. 2, at 1). The Company proposes to increase its normalized base revenues by 0.92 percent (id.). To reach this factor, the Company calculates an inflation index of 1.66 percent (Compliance Filing, att. 2, at 2). The Company then subtracts the 1.00 percent productivity growth offset, which has been approved by the Department and will remain constant throughout the life of the price cap plan. D.T.E. 01-56, at 21. Finally, the Company proposes to add an exogenous cost factor of 0.26 percent (Compliance Filing, att. 2, at 1, 3). The proposed exogenous costs comprising this factor include the cost of upgrading the Company's telephone system to comply with a change in the Department's regulatory policy applicable to gas companies in Service Quality Standards for Electric Distribution Companies and Local Gas Distribution Companies, D.T.E. 99-84 (2001), as well as the cost of security measures implemented in response to the terrorist attacks of September 11, 2001. The costs submitted for review include expenditures made during the initial 31-month rate freeze

---

2 The Company's 2003 annual service quality report, filed with the Department on March 1, 2004, indicates that Berkshire has incurred no service quality penalties in 2003. This filing is under review by the Department. See The Berkshire Gas Company, D.T.E. 04-13 (Service Quality Report).

period of the Company's performance-based rate plan (Exh. DTE-4-2, at 2). The Company does not propose any adjustment to its exogenous cost factor to include the effect of "bonus depreciation" tax relief measures enacted in 2002 and 2003.

Applying a factor of 0.92 percent to the Company's 2003 normalized base revenues of $27,325,543 results in a proposed revenue increase of $252,197. Finally, the Company proposes to reallocate this revenue increase among rate classes such that rates for selected classes increase at varying rates above and below 0.92 percent, while rates for certain classes are unchanged (Exh. DTE-1-1, att. 1). Because the Company's calculations of the inflation factor and 2003 normalized base revenues are in compliance with D.T.E. 01-56, we address only the exogenous cost and rate design issues below.

III. EXOGENOUS COSTS

A. Introduction

Incentive regulation seeks to move away from the traditional concept of "cost recovery." Incentive Regulation, D.P.U. 94-158, at 61-62 (1995). Nonetheless, the Department has recognized that some costs are beyond the control of the utility, and thus, it may be appropriate to permit recovery of exogenous costs. Id. Under the Company's price cap plan, exogenous costs are defined as:

> positive or negative cost changes actually beyond the Company's control and not reflected in the GDP-PI, including, but not limited to, cost changes resulting from:
>
> - changes in tax laws that uniquely affect the local gas distribution industry;
> - accounting changes unique to the local gas distribution industry; and

- regulatory, judicial, or legislative changes uniquely affecting the local gas distribution industry.

The Berkshire Gas Company, D.T.E. 01-56, at 25-26; cf. Boston Gas Company, D.P.U. 96-50 (Phase I) at 289-93 (1996); NYNEX, D.P.U. 94-50, at 172-73 (1995). Proponents of exogenous cost recovery bear the burden of demonstrating that the costs are (1) beyond the company's control and (2) not reflected in the GDP-PI. See D.T.E. 96-50 (Phase I) at 292, n.133; cf. id. at 291 (rejecting proposal to eliminate requirement that tax, accounting, or regulatory changes affect the local gas distribution industry "uniquely," because cost changes that are not unique to the gas distribution industry may be reflected, to some degree, in the GDP-PI); D.P.U. 94-50, at 173 ("[T]o avoid double counting, the proponent of the exogenous cost adjustment bears the burden of demonstrating that the proposed exogenous cost change has not been reflected in the GDP-PI.").

Pursuant to the Company's price cap plan, the effect of any individual exogenous cost must exceed $65,000 in a particular year before that cost will be considered in the exogenous cost factor. D.T.E. 01-56, at 23. The $65,000 threshold is based on the Company's operating revenues during the 2000 calendar year, as reported in the Company's annual return to the Department; therefore, the Department will evaluate claimed exogenous costs on a calendar-year basis. See id. at 22 n.7. Further, when determining whether costs exceed the threshold, costs are not evaluated on a cumulative basis.[3] Id. at 23.

B. Security Costs

1. Introduction

The Company implemented measures to improve security after the events of September 11, 2001 (Compliance Filing at 3). This Order does not detail those measures due to the sensitive nature of that information; however, the Company reports that it incurred costs related to installing security system upgrades (id., citing D.T.E. 01-56, Exh. DTE-2-9 (Oct. 9, 2001) [confidential]; see also Compliance Filing, supp. sch. 3, at 2). The Company asserts that these updated security costs were beyond the Company's control and were required as a result of legislative and regulatory initiatives directed to and uniquely affecting the local gas distribution industry (Compliance Filing at 3). These costs were incurred between January 1, 2002 and April 30, 2003 (Exh. DTE-4-2, at 2; see Compliance Filing, supp. sch. 3, at 2). The total cost of these security improvements was $173,675 (Compliance Filing, supp. sch. 3, at 2). The Company seeks to recover the full $173,675 plus carrying costs over the remaining 89 months of the Company's price cap plan (Compliance Filing at 3, att. 2, at 3).

---

3 Although the Department permitted the Company to defer consideration of exogenous costs during the 31-month rate freeze period until its first annual compliance filing (see D.T.E. 01-56, Letter from Karen L. Zink, Vice President and General Manager, The Berkshire Gas Company, to Mary L. Cottrell, Secretary, Department of Telecommunications and Energy (May 15, 2003)), this did not alter the requirement that the effect of individual positive or negative exogenous costs to the Company must exceed $65,000 in a calendar year before that cost will be considered in adjusting the exogenous cost factor. D.T.E. 01-56, at 22-23.

Of the total cost of $173,675, the Company spent $168,723 in 2002 and $4,952 in 2003 (Exh. DTE-4-2, at 2). Of the $168,723 spent in 2002, the Company booked $3,162.40 to operating expenses and $165,560.30 to capital, under Account 390 - Structures and Improvements (Exh. DTE-4-2, at 1-2). The entirety of the $4,952 spent in 2003 was booked to capital, under Account 390 (id.).

The Company argues that the total cost of $168,723 in 2002 exceeds the $65,000 threshold and, therefore, should be recovered as exogenous costs (Exh. DTE-4-3, at 1, citing D.T.E. 01-56, at 22). The Company submits that the method and period of depreciation of a particular asset should not determine the merits of the expenditure's qualification as an exogenous cost (id.). Thus, the Company argues that it should be allowed to recover the full cost of the security upgrades (id.).

The Company maintains that once an exogenous cost is qualified for recovery, the Department should permit recovery in either of two ways. The Company argues that rates could be adjusted to include the increased depreciation expense, to permit recovery of increased property tax expense, as well as the rate of return that would have been appropriate in the context of a normal rate proceeding (Exh. DTE-4-3, at 1). Applying this method, the Company calculates an increase for 2002 of $3,690 to adjust for additional property taxes and $15,515 to allow recovery at the rate of return on increased rate base. The Company calculates an increase for 2003 of $3,905 to adjust for additional property taxes and $15,977 to allow recovery at the rate of return on increased rate base (id.). Alternatively, the Company argues that its annual revenue requirement for the period beginning September 1, 2004 and ending August 31, 2005 could include the amount of exogenous costs associated with the security investment (id.). If the full cost of the security upgrades is recoverable over the remaining months in the Company's price cap plan, the Company calculates an annualized exogenous cost recovery plus carrying costs of $32,377 (Compliance Filing, att. 2, at 3).

2. Analysis and Findings

In order to recover the cost of security improvements as exogenous costs, the Company must first demonstrate that the annual cost incurred exceeded the $65,000 threshold. The Department found it necessary to set exogenous cost recovery thresholds in order to "avoid regulatory battles over minimal dollars." D.T.E. 01-56, at 22, citing NYNEX, D.P.U. 94-50, at 173. In NYNEX, where we first applied the concept of the exogenous cost threshold, we found that "any proposed exogenous cost adjustment must affect [NYNEX's] annual revenues by at least $3 million." D.P.U. 94-50, at 173. The Department's precedent is clear in that the threshold pertains to the resulting rate adjustment, not to the amounts spent in a year, as the Company argues.

It is inappropriate to include capitalized expenditures in considering whether an exogenous cost meets the minimum threshold. The Company's annual cost does not increase by the amount of the entire capitalized investment, but rather by the resulting depreciation attributable to that capitalized investment (Exh. DTE-4-3, at 1). The rationale for permitting exogenous cost recovery is that if the increased cost for the average-performing utility is not correlated with GDP-PI, the Company's revenues have not already been adjusted to account for such costs through the inflation factor. See NYNEX, D.P.U. 94-50, at 169, 172-73. The exogenous cost factor is applied directly to the Company's annual revenues, with no separate consideration made to account for the revenues required to provide a rate of return on rate base. D.T.E. 01-56, at 12; see also D.P.U. 96-50 (Phase I) at 284 n.131.

Moreover, capitalized investments will be considered in determining the Company's rate base when it submits its next rate case. The capital additions are being depreciated over 50 years, and will still be in service when the Company's price cap plan expires (see Exh. DTE-4-3, at 1-2). Adjusting Berkshire's rate base or revenue requirements to account for the new capital investments, as suggested by the Company, would require a full investigation of those capital adjustments, which in essence would require the Department to conduct a rate case. This would frustrate one of the primary goals of performance based regulation, which is to reduce the administrative and litigation expense of conducting rate cases by lengthening the rate case cycle and reducing the interim filings to simple annual compliance filings. Incentive Regulation, D.P.U. 94-158, at 53-55. The Company's proposal would also require a review of whether the additions were prudently made; that is, the Department would be deciding whether the level of security and type of capital investments made were appropriate, rather than leaving it to the Company to manage the economically efficient level of security.

The claimed expenditures for security improvements were $168,723 in 2002 and $4,952 in 2003 (Exh. DTE-4-1). The Company's annual expenses due to the security improvements were $4,818 in 2002 ($3,162 in operating expenses plus $1,656 depreciation expense on the new capital investment) and $3,361 in 2003 ($0 in operating expenses plus

$3,361 in depreciation expense on the new capital investment) (Exh. DTE-4-3, at 1). These expenses do not meet the $65,000 minimum threshold to qualify the expenditures for exogenous cost recovery. Therefore, the Department finds that the Company's expenditures for security improvements are not eligible for consideration as exogenous costs.[4]

C. Telephone System Upgrades

1. Introduction

The Company seeks recovery of costs associated with equipment upgrades required to satisfy mandatory service quality standards for telephone response in compliance with the guidelines established by the Department in Service Quality Standards, D.T.E. 99-84 (Compliance Filing at 2). The Company argues that it upgraded its telephone system to ensure compliance with a change in regulatory policy applicable to gas companies promulgated in D.T.E. 99-84 (id.). The Company solicited bids from multiple telephone system vendors (Exh. DTE-1-3, att. 1). The total cost of the telephone system upgrade is $292,747 (Compliance Filing, att. 2, at 3). The monthly cost, including sales tax, is $4,798.88 (Exhs. DTE-1-4, DTE-2-2). For the years, 2002, and 2003, the annual costs for the telephone system were $19,210.82 and $57,586.56, respectively (Exh. DTE-2-2).

2. Analysis and Findings

The Company proposes to include the total cost of the telephone system upgrades for 2002 and 2003 as an exogenous cost. In approving the Company's price cap plan, we

---

4 Even if the company were allowed to include property tax expense and return on rate base, security costs would fall below the $65,000 threshold (Exh. DTE-4-3, at 2).

expressly rejected the Company's proposal to consider exogenous costs on a cumulative basis. D.T.E. 01-56, at 23. The annual costs of the telephone system upgrades of $19,210.82 in 2002 and $57,586.56 in 2003 do not exceed the Company's exogenous cost threshold of $65,000. Therefore, the Company's telephone upgrade costs for the years 2002 and 2003 are not eligible for consideration in adjusting the Company's exogenous cost factor.

D. Bonus Depreciation

1. Introduction

The Attorney General notes that the Compliance Filing did not address whether ratepayers are entitled to an exogenous cost reduction to account for a new bonus depreciation tax provision (Attorney General Comments at 1, citing 26 U.S.C. § 168(k) ("Internal Revenue Code")). Section 168(k) of the Internal Revenue Code allows a bonus depreciation deduction of 30 percent for seven-year and 20-year utility assets placed in service after September 10, 2001, and 50 percent for assets placed in service after May 5, 2003, but before January 1, 2005.[5] The issue here is whether the tax law change associated with the allowance of bonus depreciation and resulting deferred income tax triggers a negative exogenous cost under the Company's price cap plan.

The Company argues that the tax benefits resulting from bonus depreciation should not be treated as an exogenous cost, nor be reflected in its distribution rates, because the plant that

---

[5] The 30 percent bonus provision was enacted by the Job Creation and Worker Assistance Act of 2002, Pub. L. No. 104-107, § 101, 16 Stat. 21, 22-25 (codified at 26 U.S.C. § 168(k)). The 50 percent bonus provision was subsequently enacted by the Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 201, 117 Stat. 752, 756 (codified at 26 U.S.C. § 168(k)).

gave rise to these benefits, i.e., post September 11, 2001 eligible additions, was not included in the December 31, 2000 rate base upon which its current rates are based (Exh. DTE-2-1). If adjustments are made to its distribution rates because of bonus depreciation, the Company maintains that corresponding adjustments must be made for the depreciation expense and property tax expense associated with these additions, as well as the allowance of a return on these investments (Exh. DTE-3-7).

2. Analysis and Findings

Under the Company's price cap plan, exogenous costs are defined as costs that are beyond the Company's control and not reflected in the GDP-PI. Such costs include those related to changes in tax laws, accounting principles, and regulatory, legislative, or judicial action "uniquely affecting the local gas distribution industry." D.T.E. 01-56, at 26; see also D.P.U. 96-50 (Phase I) at 289-93. We have found that costs not uniquely affecting the local gas distribution industry may be incorporated, to some degree, in the GDP-PI. D.P.U. 96-50 (Phase I) at 291.

Section 168(k) of the Internal Revenue Code provides broad tax relief available to any taxpayer that has placed in service qualifying property after September 10, 2001 but before January 1, 2005. 26 U.S.C. § 168(k). The bonus depreciation tax benefit, therefore, is not limited to local gas distribution companies. Moreover, Congress enacted these tax measures in order to provide broad growth incentives for businesses in order to create jobs.[6] Because these

[6] Job Creation and Worker Assistance Act of 2002; Jobs and Growth Tax Relief Reconciliation Act of 2003.

measures should have a broad macroeconomic effect, the tax benefit will be incorporated to some degree in the GDP-PI. Therefore, the benefit of the tax change does not fall within the definition of exogenous cost under the Company's price cap plan.[7]

III. RATE DESIGN

A. Introduction

The Company proposes rate adjustments that vary among rate classes in order to recover the total proposed revenue change with certain rate classes not bearing any of the proposed rate adjustment (Exh. DTE-1-1, att. 1). The manner in which the Company proposes to allocate the revenue adjustment among rate classes results in percentage rate increases that vary for certain rate classes and are greater than the overall rate increase: R-1, R-2, R-3, and R-4 (id.).[8]

The Company argues that rates should be rebalanced, because revenues from certain customer classes "did not provide their equalized rate of return as determined in the recent marginal cost study relied upon in D.T.E. 01-56" (Compliance Filing at 4). The Attorney General argues that the Company has exceeded its rate design flexibility under the price cap

---

[7] Although the Attorney General notes that Massachusetts Electric Company has proposed treating the tax change as an exogenous cost in Massachusetts Electric Company, D.T.E. 03-124, our finding here does not affect that case (Attorney General Comments at 1-2). Massachusetts Electric Company's rates are not subject to a price cap form of regulation, under which rates are tied to an inflation factor and productivity growth rather than to the cost of service.

[8] The Company proposes to allocate the rate adjustment among the core rate classes as follows: R-1, 1.58 percent; R-2, 1.58 percent; R-3, 1.42 percent; R-4, 1.45 percent; Gas Lights, 0.71 percent; G-41, 0.71 percent; G-42, 0.00 percent; G-43, 0.00 percent; G-51, 0.00 percent; G-52, 0.00 percent; G-53, 0.00 percent; and T-54, 0.17 percent (Exh. DTE-1-1, att. 1).

plan, because the Company has provided no justification for proposing an interclass rate adjustment (Attorney General Comments at 1 n.1, citing, D.T.E. 01-56, at 28; D.P.U. 96-50 (Phase I) at 333-34).

B. Analysis and Findings

The Company's price cap plan provides that the overall price change percentage will be applied to each core rate class to determine the total revenue change for each core rate class. D.T.E. 01-56, at 26-27. In approving the plan, the Department allowed the Company limited intraclass rate design flexibility to allocate the price cap change to the individual rate components within each class, so long as no rate component increases by more than the rate of inflation.[9] Id. The Department did not allow interclass rate design flexibility to allocate the price cap change among classes within the context of a compliance filing. See id. The revenue adjustment for each core rate class must result in a revenue percentage increase equal to the rate provided by the price cap formula. The Company's proposed rate design does not comply with the Company's price cap plan, because it does not apply the overall price change percentage to determine the total revenue change for each class. D.T.E. 01-56, at 26-27.

---

[9] If the overall price change is greater than the rate of inflation because of the recovery of exogenous costs, the Company has intraclass rate design flexibility to increase each rate component at no more than the rate provided by the price cap formula. D.P.U. 01-56, at 26-27. This flexibility does not apply here, because we are not adjusting the price cap rate adjustment by an exogenous cost factor, and the resulting price change is less than the rate of inflation.

IV. CONCLUSION

Because we find that the Company is not eligible to include an exogenous cost factor in its price adjustment factor, and because the Company's proposed rate design is not in compliance with D.T.E. 01-56, the Department rejects the Company's Compliance Filing and directs the Company to file revised tariffs in compliance with the directives set forth herein. The Company is permitted to recover an overall rate adjustment of 0.66 percent (1.66 percent inflation factor minus 1.0 percent productivity offset). Further, the Department directs the Company to resubmit a rate design that limits the rate increase to 0.66 percent to each core rate class (i.e., R-1, R-2, R-3, R-4, Gas Lights, G-41,G-42, G-43, G-51, G-52, G-53, and T-54) in order to determine the total revenue change for each core rate class as required by the Company's price cap plan. See D.T.E. 01-56, at 26-27.

V. ORDER

Accordingly, after due notice and consideration, it is

ORDERED: That the tariffs M.D.T.E. Nos. 343 through 349, filed by The Berkshire Gas Company on May 14, 2004, to become effective September 1, 2004, are DISALLOWED; and it is

FURTHER ORDERED: That The Berkshire Gas Company shall file new schedules of rates and charges that are consistent with the directives contained herein.

By Order of the Department,

/s/
Paul G. Afonso, Chairman

/s/
W. Robert Keating, Commissioner

/s/
Eugene J. Sullivan, Jr., Commissioner

/s/
Deirdre K. Manning, Commissioner

Appeal as to matters of law from any final decision, order or ruling of the Commission may be taken to the Supreme Judicial Court by an aggrieved party in interest by the filing of a written petition praying that the Order of the Commission be modified or set aside in whole or in part.

Such petition for appeal shall be filed with the Secretary of the Commission within twenty days after the date of service of the decision, order or ruling of the Commission, or within such further time as the Commission may allow upon request filed prior to the expiration of twenty days after the date of service of said decision, order or ruling. Within ten days after such petition has been filed, the appealing party shall enter the appeal in the Supreme Judicial Court sitting in Suffolk County by filing a copy thereof with the Clerk of said Court. (Sec. 5, Chapter 25, G.L. Ter. Ed., as most recently amended by Chapter 485 of the Acts of 1971).